

Message Text

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TO SECSTATE WASHDC 889

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SUBJ: ANALYSIS OF ECONOMIC IMPACT OF THE GOP'S NEW

AUSTERITY PROGRAM

REF: LIMA 6017

1. BEGIN SUMMARY - MEASURES ENACTED BY THE GOP CONSTITUTE AN ECONOMIC AUSTERITY PROGRAM WHICH ATEMPTS TO AVOID TWIN ECONOMIC DISASTERS: RUNAWAY INFLATION AND AN INTERNATIONAL PAYMENTS CRISIS. THE SIGNIFICANT IMPACT OF THE PROGRAM IS UPON WAGES, PRICES, FISCAL REVENUES AND EXPENDITURES, AND BALANCE OF PAYMENTS. THE CRITICAL MASS OF THE PROGRAM IS THE SHARP DEVALUATION OF THE PERUVIAN SOL. SPECIFICS OF MEASURES IMPLEMENTING THE PROGRAM WERE OUTLINED IN LIMA 6017. END SUMMARY.

2. INCOMES POLICY - THE WAGE INCREASES DECREED BY GOP

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RANGE DOWNWARD FOR 14 PERCENT FOR MONTHLY WAGES BETWEEN

FIVE AND SEVEN THOUSAND SOLES (AVERAGE \$92) TO 10 PERCENT FOR MONTHLY WAGES BETWEEN THIRTEEN AND FIFTEEN THOUSAND SOLES (AVERAGE \$215) AND ARE LIMITED TO AN INCREASE OF 1,500 SOLES FOR MONTHLY WAGES IN EXCESS OF FIFTEEN THOUSAND SOLES. ALTHOUGH WORKERS WITH MONTHLY WAGES IN EXCESS OF FIFTEEN THOUSAND SOLES MIGHT NOW BE WORSE OFF IN REAL TERMS, THE BEHAVIOR OF REAL WAGES WILL DEPEND UPON THE INCREASE IN THE COST OF LIVING RESULTING PRINCIPALLY FROM THE DEVALUATION.

3. DEVALUATION AND INFLATION - IN 1975-1976 PERU'S IMPORTS OF GOODS AND SERVICES WERE EQUIVALENT TO 20.3 PERCENT OF GROSS DOMESTIC PRODUCT AND TO 18.8 PERCENT OF THE SUM OF GROSS DOMESTIC CONSUMPTION AND GROSS DOMESTIC INVESTMENT. A 44.4 PERCENT INCREASE IN THE COST OF IMPORTS AS WORKED THROUGH THESE RATIOS SUGGEST INCREASES IN OVERALL PRICE LEVELS OF 9.0 PERCENT AND 8.4 PERCENT RESPECTIVELY. HOWEVER, IN THESE CALCULATIONS REDUCTION OF TWENTY PERCENT OF DOMESTIC PRODUCT TO ALLOW FOR PRODUCTION OUTSIDE THE CASH ECONOMY WOULD BE APPROPRIATE BECAUSE IMPORTS ARE RELATED PRINCIPALLY TO THE MONETIZED ECONOMY. THIS CONSIDERATION WOULD RAISE THE PERCENTAGE RATES OF INFLATION NOTED ABOVE TO 11.3 PERCENT AND 10.5 PERCENT RESPECTIVELY. IN ADDITION, INFLATIONARY PRESSURES ARE TRANSMITTED BY EXPORT GOODS ALSO PRODUCED FOR THE DOMESTIC MARKET, E.G. SUGAR, COTTON, WOOL, BUT IN AGGREGATE THESE GOODS ARE A SMALL PORTION OF TOTAL EXPORTS AND ARE EASILY SUBJECT TO GOVERNMENTAL ACTIONS TO CONTROL THEIR PROCES. A SECOND METHOD FOR GAUGING INFLATIONARY PRESSURE IS TO EXAMINE THE LIMA-CALLAO CONSUMER PRICE INDEX. AT THE LEVEL OF SUB-GROUPS, 31 PERCENT OF THIS INDEX IS READILY ASSOCIATED WITH IMPORTED GOODS. THE GROUPS AND WIGHTS (IN PARENTHESES) ARE AS FOLLOWS: GRAINS AND DERIVATIVES (6.83), MEAT AND MEAT PRODUCTS (10.92), FATS AND EDIBLE OILS (1.62), ELECTRICITY AND FUEL (2.98), TRANSPORTATION (5.08), VEHICLES AND RELATED ITEMS (3.19). THE TOTAL (30.6 PERCENT) WOULD IMPLY AN INCREASE IN THE CONSUMER PRICE INDEX OF 13.6 PERCENT.

4. PRICE CONTROLS - ON JULY 2 THE GOP POSTED A NEW LIST OF PRICES FOR TWENTY FOODSTUFFS. THE PRICE OF RICE WAS INCREASED BY 21 PERCENT, PASTEURIZED MILK BY 28 PERCENT, CONDENSED MILK LIMITED OFFICIAL USE

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BY 20 PERCENT, SECOND QUALITY BEEF BY 23 PERCENT, CHICKEN BY 11 PERCENT, NOODLES BY 26 PERCENT, FRENCH BREAD BY 26 PERCENT, FLOUR BY 50 PERCENT, BREAD BY 11 PERCENT, COMMON COOKING OIL BY 56 PERCENT, VEGETABLE OIL BY 32 PERCENT, AND PACKAGED MARGARINE BY 19 PERCENT. THE GOVERNMENT HAS ANNOUNCED THAT IT WILL SUBSIDIZE FOOD PRICES IN AMOUNT OF TWO BILLION SOLES (30.8 MILLION DOLLARS) DURING THE SECOND HALF OF 1976. THE MOVEMENT IN THE CONSUMER PRICE INDEX (CPI) DURING THE SECOND

HALF OF 1976 DEPENDS ON AN AMALGAM OF FORCES: (1) THE DEVALUATION; (2) SUBSIDIES TENDING TO REDUCE PRICES OF CERTAIN PRODUCTS WITH HIGH IMPORT INCIDENCE (WHEAT, BEEF); (3) THE INCREASE IN THE PRICE OF GASOLINE (WHICH SUBSTANTIALLY EXCEEDS THE PERCENTAGE OF THE DEVALUATION); AND (4) THE GOP'S MANAGEMENT OF SPECULATIVE FORCES UNLEASHED BY THE DEVALUATION. DURING THE FIRST FIVE MONTHS OF 1976 THE CPI INCREASED BY 12.3 PERCENT. DESPITE THE FOODSTUFF SUBSIDIES AND A TOUGH LINE ON SPECULATORS, WE ESTIMATE, AS A MINIMUM, THAT THE DEVALUATION AND THE INCREASE IN URBAN AND OTHER TRANSPORT COSTS WILL CAUSE A 30 PERCENT INCREASE IN THE CPI FOR THE 12 MONTH PERIOD FROM DECEMBER 1975 TO DECEMBER 1976. DEPENDING PRINCIPALLY UPON MONETARY FACTORS, AND INCREASE OF UP TO 40 PERCENT MAY BE MORE PROBABLE.

5. INCREASED FISCAL REVENUES - IT IS QUITE CLEAR THAT THE GOP HAS SOUGHT TO MAXIMIZE FISCAL REVENUE WITH VARIOUS MEASURES ENACTED SIMULTANEOUSLY WITH DEVALUATION. DECREE LAW 21528 ESTABLISHES A 15 PERCENT TAX ON TRADITIONAL EXPORT COMMODITIES BASED ON FOB VALUE AND DECREE LAW 21529 CREATES A 15 PERCENT TAX ON THE SALE PRICES OF PRODUCTS WHOSE PRICES ARE SET BY INTERNATIONAL MARKET. (FYI A NOTABLE EXCEPTION TO 15 PERCENT TAX WILL BE CUAJONE COPPER PRODUCTION. SEE SEPTTEL. END FXD) THUS, A NEW TAX OF 9.75 SOLES WILL BE PAID ON THE BULK OF PERU'S EXPORT COMMODITIES (THE EXPORTER RECEIVES 55.25 SOLES AS A MAXIMUM INSTEAD OF 65 SOLES PER U.S. DOLLAR FOB VALUE). A RECENT GOP ESTIMATE OF THE FOB VALUES OF PERU'S PRINCIPAL TRADITIONAL EXPORTS TOTALED \$1,306 MILLION. THESE EXPORTS INCLUDE COPPER, IRON ORE, SILVER, LEAD, ZINC, FISHMEAL, COTTON, SUGAR, COFFEE, AND WOOL. THEREFORE, THE NEW EXPORT TAX WOULD YIELD 12.7 BILLION SOLES ON AN ANNUAL BASIS (EXCLUSIVE OF THE TAX REVENUES FROM DOMESTIC CONSUMPTION SALES OF FISHMEAL, SUGAR, LIMITED OFFICIAL USE

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AND COTTON). FISCAL REVENUES ARE ALSO INCREASED BY A SHARP INCREASE IN THE PRICE OF GASOLINE. THE RETAIL PRICE OF 95 OCTANE GASOLINE WAS INCREASED TO 80 SOLES PER GALLON (FROM 42 SOLES) AND THE RETAIL PRICE OF 84 OCTANE GASOLINE WAS INCREASED TO 50 SOLES PER GALLON (FROM 23 SOLES), PRICE INCREASES OF 90 PERCENT AND 117 PERCENT RESPECTIVELY. PRIOR TO DECREE LAW 21534, TAXES PER GALLON FOR 95 OCTANE GASOLINE RANGED FROM SLIGHTLY LESS THAN 6 SOLES TO 6.65 SOLES (DEPENDING ON GEOGRAPHICAL REGION) AND TAXES PER GALLON FOR 84 OCTANE GASOLINE RANGED FROM FOUR CENTAVOS TO 3.57 SOLES, WITH MOST TAXES AT MOST LOCATIONS IN EXCESS OF 3 SOLES PER GALLON. THE TAX INCREASE APPROXIMATES 24 SOLES PER GALLON FOR 95 OCTANE GASOLINE AND 19 SOLES PER GALLON FOR 84 OCTANE GASOLINE. DOMESTIC SALES OF GASOLINE IN PERU APPROXIMATED 556 MILLION GALLONS IN 1975 AND 527 MILLION GALLONS IN 1974.

AS A MINIMUM WE ESTIMATE INCREASED ANNUAL FISCAL REVENUE FROM HIGHER TAX ON GASOLINE AT 10 BILLION SOLES (20 SOLES PER GALLON INCREASE IN TAX MULTIPLIED BY 500 MILLION GALLONS). OUR CALCULATIONS INDICATE HIGHER TAX REVENUES FROM EXPORTS AND GASOLINE AT 22.7 BILLION SOLES ON AN ANNUAL BASIS AS COMPARED TO THE 22.5 BILLION SOLES ESTIMATED BY MINISTER BARUA.

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6. BUDGETARY REDUCTIONS - THE GOP CUT THE CENTRAL GOVERNMENT'S 1975-76 BIENNIAL INVESTMENT BUDGET BY 4.5 BILLION SOLES. CUTS BY ENTITIES ARE AS FOLLOWS (STATED IN MILLIONS OF SOLES):

MINISTRY OF AGRICULTURE	- 600
MINISTRY OF FISHING	- 550
MINISTRY OF INDUSTRY AND TOURISM	- 600
MINISTRY OF FOOD	- 800
MINISTRY OF TRANSPORTATION AND COMMUNICATION	- 900

MINISTRY OF HOUSING AND CONSTRUCTION - 350
 MINISTRY OF EDUCATION - 140
 MINISR
 Y OF HEALTH - 140
 OWORDEZA - 100
 SINAMOS - 50
 ORG. BAYOVAR - 270
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4,500

THE GOP CUT THE INVESTMENT BUDGETS OF TWELVE STATE ENTERPRISES
 BY 9,666 BILLION SOLES. CUTS BY ENTITIES ARE AS FOLLOWS
 (STATED IN MILLIONS OF SOLES):

SIDERPERU (STEEL)	250
EMSAL (SALT)	27
ENTURPERU (TOURISM)	50
EMP. PUBLICA IND. CACHIMAYO (FERTILIZER)	6
INDUPERU (INDUSTRIAL FINANCING)	375
ENAPU (PORT FACILITIES)	185
CORPAC (AIRPORTS)	46
ENTELPERU (TELEPHONES AND COMMUNICATIONS)	165
SIMA (SHIP BUILDING)	580
PETROPERU (PETROLEUM)	4,000
MINEROPERU (MINING)	3,415
ELECTROPERU (ELECTRICITY)	567
	9,666

THE IMPRESSION THAT THE GOP HAS DECIDED AT THIS TIME TO
 TRIM NEARLY 14.2 BILLION SOLES OF EXPENDITURES FROM ITS
 BUDGET IS MISLEADING. SOME REDUCTIONS HAD BEEN PLANNED
 EARLIER. FOR EXAMPLE, WE WERE INFORMED OF THE CUTS FOR
 PETROPERU AND MINEROPERU ON MAY 20. THE EXPLANATION
 GIVEN WAS THAT THE CENTRAL BANK HAD NO INTENTION OF
 ALLOWING THE MONETARY PROGRAM TO BE DESTROYED THROUGH
 ACCOMMODATING THESE REQUESTS. (COMMENT IT IS INTERESTING
 TO NOTE THAT NO BUDGET CUTS WERE ANNOUNCED FOR UNIFORMED
 SERVICES. THIS MAY BE DUE EITHER TO FACT THAT MILITARY
 BUDGET IS STATE SECRET, OR MAY SIMPLY INDICATE THAT ARMED
 FORCES BUDGET WAS NOT REDUCED.)

7. NET FISCAL IMPACT OF RECENT MEASURES - ANY ESTIMATE OF
 NET IMPACT OF RECENT MEASURES ON CENTRAL GOVERNMENT FINANCE
 IS OBVIOUSLY ON SLIPPERY GROUND. OUR ESTIMATE OF THE IMPACT
 OF THE JUNE 30 DEVALUATION AND ACCOMPANYING TAX AND INCOME
 PACKAGE ON FISCAL OPERATIONS DURING THE SECOND HALF OF 1976
 IS AS FOLLOWS: (A) A 3.7 BILLION SOL INCREASE IN WAGE BILL
 DUE TO HIGHER WAGES, (B) A 2.0 BILLION SOL REDUCTION IN
 WAGE BILL DUE TO THE FREEZE ON HIRING AND PROMOTION, (C) A

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2.0 BILLION SOL INCREASE DUE TO NEW FOOD SUBSIDIES, (D) AN 8.7 BILLION SOL INCREASE IN DEBT SERVICE DUE TO DEVALUATION, FNE) AN 11.4 BILLION SOL INCREASE IN REVENUES FROM NEW EXPORT TAX AND INCREASED TAX ON GASOLINE, AND (F) A 4.5 BILLION SOL CUT IN CENTRAL GOVERNMENT INVESTMENT EXPENDITURES. THE NET IMPACT IS A 3.5 BILLION SOL REDUCTION IN THE CENTRAL GOVERNMENT'S ECONOMIC DEFICIT; I.E. FINANCIAL DEMAND ON THE BANKING SYSTEM. THE TARGET FOR THE NEW TAX MEASURES ANNOUNCED IN THE PERIOD MAY 18 TO JUNE 30 AND 6 TO 7 BILLION SOLES OF ADDITIONAL REVENUE FOR THE SECOND HALF OF 1976. SEE LIM'S 4695 AND 4883. HOWEVER, WE WERE INFORMED THAT THIS NEW REVENUE WOULD COVER PRINCIPALLY EXPENDITURES THAT WERE OUTDISTANCING BUDGETED LEVELS. WE DOUBT, THEREFORE, THAT THE EFFECT OF THE EARLIER TAX PACKAGE PLUS THE NEW TAX PACKAGE DOES MUCH TO REDUCE THE 25 BILLION SOL DEFICIT TO BE FINANCED BY THE DOMESTIC BANKING SYSTEM. THE FISCAL RESULT OF INFLATION AND DEVALUATION IS THAT THE GOP IS HAVING TO DO A LOT OF RUNNING MERELY TO STAY IN PLACE.

8. BALANCE OF PAYMENTS IMPACT - APART FROM THE POSSIBLE IMPACT OF THE GOP'S NEW AUSTERITY PROGRAM UPON A POTENTIAL IMF STAND BY, OR OTHER EXTERNAL CREDIT PACKAGE, THE HIGHER PRICE FOR IMPORTS WILL HAVE THE SALUTARY EFFECT OF A PRICE-DIRECTED RESTRAINT OF IMPORTS. DECREE LAW 21496, REPORTED IN LIMA'S 5688, ESTABLISHED AN ANNUAL NATIONAL PROGRAM OF COMMODITY IMPORTS AND RELATED FOREIGN EXCHANGE BUDGET. SOLE RELIANCE UPON THE ADMINISTRATIVE SYSTEM OUTLINED IN THIS LAW AND AN EXCHANGE RATE OF 45 SOLES PER U.S. DOLLAR WOULD, WE JUDGE, BE DISRUPTIVE TO IMPORTS AND PROBABLY DISRUPTIVE TO THE PERUVIAN ECONOMY. ALTHOUGH NO OFFICIAL ACTION HAS BEEN TAKEN TO RESCIND THIS SYSTEM, IF ADEQUATE B/P FINANCING IS FORTHCOMING, IMPLEMENTATION OF THIS NEW IMPORT CONTROL SYSTEM MIGHT NOT TAKE PLACE.
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